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Hallwood Realty Partners L.P.: First Rescue Rollup Proposed

Limited partners of 11 syndications sponsored by Equitec Financial Corp. are being asked to combine their partnerships into Hallwood Realty Partners L.P., a proposed new master limited partnership (MLP).

Hallwood Realty Partners (HRP) would start life as a major player in the office market, owning about 7.0 mil. sq. ft. of space divided 4.4 mil. sq. ft. of downtown and suburban offices in key urban areas. HRP would also own 2.4 mil. sq. ft. industrial buildings and about 196,000 sq. ft. shopping centers and retail space. HRP would own about \$534.7 mil. assets at appraised value, less about \$290.2 mil. debt and other liabilities, or about \$244.6 mil. net current equity value.

The Hallwood Realty proposal marks the first time a real estate syndicator has agreed to turn over administrative control and property supervision to a new general partner. The new HRP would be managed by a subsidiary of Hallwood Group Incorporated, a company specializing in rescue financing mainly in real estate, energy and financial industries.

A prospectus asking over 80,000 limited partners to approve the combination has cleared the S.E.C. and is being mailed to limited partners (LPs) of the 11 partnerships. Like all rollups (i.e., the combination of several limited partnerships into a single master limited partnership), the proposal holds the prospect of providing stock market liquidity to L.P. units which heretofore have had very limited trading markets. And like other MLP proposals, the Hallwood Realty proposal is complex. Salient details:

The Rescuer: Hallwood Group

Incorporated (HWG:NYSE—7), the rescuer chosen by Equitec, is a \$129 mil.-asset veteran white knight in restoring life to troubled companies. HWG was formed from the 1984 union of two construction lending REITs of the 1970s. Under English businessman Anthony Gumbiner, HWG has developed a unique merchant banking business in rescue financing and restructuring. HWG enters troubled situations only on a friendly basis, marshalling resources of both foreign and domestic investors to resuscitate sick companies. For its efforts HWG gets a management fee, often taken in stock of the rescuee, and control during transition. After health is restored, HWG usually sells its stake.

In real estate, HWG renovated and remerchandised properties held by its original REITs, UMET Trust and First Pennsylvania Mtg., selling most properties at enhanced values over a period of years. In 1984 HWG funded through a Luxembourg company, Stanwick Int'l. Corp., the purchase of properties and mortgages formerly held by Twenty-Seven Trust, which had been formed by banks to dispose of assets of the bankrupt Chase Manhattan Mtg. & Realty Trust. Today HWG owns directly about \$23 mil. real estate assets in the U.S. and in England, and manages about another \$20 mil. assets for Stanwick.

In recent years HWG entered rescue operations in fields allied to real estate. It has restructured and holds interests in Heck's Inc. (HEXX:OTC), a Midwestern discount retailer; ShowBiz Pizza Time (SHBZ:NASDAQ), one of the few stocks making new highs in recent weeks; and Hallwood Energy Partners L.P. (HEP:ASE), a recently completed rollup and merger of numerous energy limited

partnerships. HWG also has restructured Integra, A Hotel and Restaurant Co. (IRG:NYSE), BancTEXAS Group of Dallas and Coated Sales Inc., a nylon textile converter.

The Rescuees: Equitec Financial Group Inc. (EFG:NYSE—7/32), and 11 syndications it sponsored have come under severe financial pressures in recent months. EFG, which is 49.5% controlled by Portland, Ore. utility giant PacifiCorp, reported losing \$2.84 and \$3.41 per share (or \$14.1 and \$16.9 mil.) in 1989 and 1988 respectively. Net worth has turned negative by \$0.14/sh. Under severe liquidity pressures, EFG skipped March 1, 1990 interest payment on \$20 mil. of 10% convertible debentures due 2004. And interest payments on \$20.1 mil. of 12% senior subordinated debentures due 1993 became payable June 15. The March 1 miss put EFG in default of \$20.1 mil. short-term credit (\$10 mil. owed to banks and \$10.1 mil. revolving credit agreement with PacifiCorp which expired April 1). EFG says continued operations depend upon its ability to restructure debt.

The catch is that EFG itself—and not any of its subsidiaries—acts as general partner (GP) for the 11 programs proposed to be included in HRP. EFG adopted this unusual sponsorship structure originally to meet the 10% equity requirement for general partners under I.R.S. rules. That corporate responsibility for EFG's programs has limited EFG's maneuvering room and late last year EFG concluded "that a combination whereby Equitec remained as the general partner of a new consolidated entity would not be in the best interest of the limited partners....or of its own shareholders."

Now EFG's tenuous finances and its default on one public bond issue raises questions about whether it can escape bankruptcy. So far the presence of EFG's financially strong 49% owner has induced creditors to grant credit extensions to date. But if EFG were pushed into bankruptcy, we believe the partnerships could be forced into Chapter XI as well.

Under these siege conditions, Equitec agreed last Oct. to transfer its general partnership interests to Hallwood and is recommending the rollup. If the rollup is approved, EFG would receive between \$6.7 and \$14.75 mil., depending upon the number of partnerships which participate in HRP. These payments depend upon the number of participating partnerships and would cover the maximums of (1) \$9.0 mil. for various Exchange and transitional expenses from HRP; and (2) 5.75 mil. to purchase Equitec's general partnership interests from HWG. If any partnership votes not to participate in HRP, EFG intends asking non-participating limited partners for consents to transfer EFG's GP interests to Hallwood later.

The partnerships themselves haven't done well either: they lost a combined \$158 mil. over the past three years, dropping about 30% of \$565 mil. original equity capital. Eight have halted regular payouts and several have lost properties to foreclosures.

The Rescue Deal: LPs of 11 Equitec syndications are being asked to exchange their LP units for units of HRP in a taxfree exchange. If all syndications go along, HRP would issue 9,359,575 new MLP units. Dean Witter Reynolds is acting as dealer-manager. The rescue deal has these elements which influence an LP's decision on the proposal:

Allocation of units. The number of MLP units per LP unit of each syndication is determined by a current appraisal of properties and net other assets owned by each partnership, discounted by 50% "intended to reflect the fact that securities markets typically discount the underlying value of real estate and other assets held by issuers" such as HRP. The resulting exchange value was then divided by \$15, an arbitrary number, to allocate evenly the number of new HRP units to be exchanged for each LP unit of the underlying partnerships. This discount procedure is applied to make the deal work in the stock market, and the effect is to halve the number of HRP units to be distributed and double the distribution per unit that otherwise would be received. To our knowledge, this is the first time a market discount was applied to derive exchange values in allocating new MLP units.

Exchange values are based on appraisals of all properties by the national realty firm of Cushman & Wakefield Inc., using consistent appraisal standards. This part of the process is the same one used in other rollups, since it aims to allocate MLP units to participating syndications and their LPs by valuing properties on a consistent basis. (Appraised value is not an estimate or guarantee of HRP's ultimate trading value.)

The appraisals mark all properties held by the 11 syndications to today's real estate market. While some syndications absorb losses and others record gains as a result of the appraisal process, the total appraised value of \$534.7 mil., before mortgage debt and other liabilities, equals almost exactly original property cost. Because HRP would continue to carry assets at historic cost, HRP would begin life with \$24.24 per unit net asset value. Accumulated depreciation would equal \$12.79/unit, or combined historic cost adjusted value of \$37.03/unit.

Liquidity: HRP's units would be listed on the ASE under the symbol HRY as soon as possible after the closing, providing a liquid trading market to LP units which have had an uncertain market at best until now. Like most LP units, the Equitec syndications have traded infrequently in an informal market dominated by about a dozen firms which generally bid relatively low prices for distressed LP units. For the first time in any rollup, the prospectus strips some mystery from after-market trading prices and tallies prices reported by three of these after-market trading firms. Surprisingly, transactions reported for the only two funds showing trading during 1990 are well below the discounted exchange value being offered to LPs. Fund REI 83 for instance traded at \$85 per unit, or 22% below the \$109 exchange value; Fund XVI also traded at \$85, or 46% below a \$157 exchange value. Exchange values for Funds XIII and XV are 26% and 133% respectively over the highest reported prices during the Dec., 1989 quarter.

The ASE listing would substitute the established auction market of a stock exchange, with transactions possible at any time at commissions significantly lower than in LP markets. The prospectus carefully cautions that neither the appraised value nor the discounted exchange value are to be taken as a prediction of market value, even though HRP units are being allocated for each \$15 of exchange value. While some syndication sponsors resist liquidity for units, our experience is that liquidity generally benefits LPs. The after-market trading experience described above simply confirms our long-held suspicions: LPs are at a

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severe disadvantage if they have to trade their units in this chaotic market where broker-dealers aren't required to find the best possible execution price for customers. The ASE auction market may not be perfect but it seems far superior to the disjointed after-market portrayed in this prospectus. Bottom line: HRY's future market price ultimately will depend upon performance of the entity and not the inequality of today's after-market.

Income. HRP intends paying \$1.50 per unit distributions during the first year following completion of the offer, and will pay substantially all net cash flow thereafter. Eight of the 11 syndications, generally those sold in the early and mid-1980s and intended to generate tax losses instead of cash flow, aren't making regular distributions. Hallwood commits to making these distributions by agreeing to (1) cut effective management fees from 6% to 1% of gross rents and (2) limit general and administrative expenses to \$2.5 mil. per year for HRP's first two years of operations. These two items generate pro forma annual expense savings of \$5.2 mil. or 56¢/unit pro forma, and we estimate savings could ultimately reach 70¢-75¢/un. These savings are key in the dividend commitment, and in our opinion should help support HRP's after-market price. Investors in eight of the 11 LPs would get payouts restored under the proposal, while three would take modest cuts.

Blended LPs. If approved, HRP would blend syndications with two widely varying original goals, depending upon the syndication market when Equitec sold the programs, as follows:

—**High Leverage, Low Cash Flow, Tax Losses.** The first five listed in the table below were sold before May 1986, when tax-loss syndications were popular, and raised \$487.2 mil. equity. These LPs bought major urban properties using about \$2 debt for each \$1 equity to maximize tax losses and minimize cash flow. As a result these five have aggregate exchange values (excluding distributions) averaging \$228 per \$1,000 investment but would own 82% of HRP's equity because of their large size.

—**Low Leverage, High Income, Low Losses.** The six others were sold after May 1986, when Congress began changing tax laws to clamp down on tax losses. As a result they raised only \$78.1 mil. equity and generally bought unleveraged properties so they could generate income for investors. Aggregate exchange values average \$330 per \$1,000 investment. The following table shows aggregate exchange values accorded each LP:

	Disc. Exch. (Mil.\$)-a	Net Val.	Total HRP Un.(Th.)	Exch. Ratio/ LP Un.	—Per \$1,000 Original Investment	Exch. Val.	Total Investment
REI 83-x	\$19.71	1,313	7.2980	14.5960	\$218.94	\$95	\$313.44
Fund XIII-x	11.26	753	4.1702	8.3404	125.11	62	187.18
Fund XIV-x	14.55	971	5.3874	10.7748	161.62	39	200.42
Fund XV-x	38.53	2,571	10.7036	21.4072	321.11	77	398.59
Fund XVI-x	30.62	2,041	10.4961	20.9922	314.88	111	426.01
Fund 17	7.49	500	11.4917	22.9834	344.75	89	433.80
Fund 18	4.84	322	10.5610	21.1220	316.83	57	373.56

Fund A	2.88	192	5.0474	20.1896	302.84	220	523.24
Fund B	4.24	282	5.0576	20.2304	303.46	223	526.42
Fund C	4.32	288	5.9184	23.6736	355.10	203	557.74
Fund 4	1.91	127	11.8494	23.6988	355.48	142	497.40
Tot./Avg.	\$140.33	9,360			\$283.65	\$120	\$403.44

a-Exchange values above are 99% of net equity plus net other assets, discounted by 50%. b-Includes distributions paid and payable, rounded to nearest dollar. x-Higher leverage funds originally sold to generate tax losses; others mainly for income.

Diversification and operating efficiency. HRP would own 27 properties diversified geographically and by property type. HRP thus would be less dependent than any underlying partnership upon any one property type or location. HRP holdings would include 13 office properties with 4.375 mil. sq. ft. and accounting for 78% of appraised value; seven industrial/flex space properties with 2.388 mil. sq. ft. and 18% of appraised value; and seven retail properties with 195,700 sq. ft. and 4% of appraised value. Properties are located in 13 states. None of the syndications owns interests in more than five properties and two own one property.

Seven major properties account for over two-thirds (or \$364 mil.) of appraised value. These largest properties would be:

Two North LaSalle St. office in Chicago, 692,279 net rentable sq. ft. and 85% occupied, valued at \$87 mil., and owned by Fund REI 83;

East-West Towers, Bethesda, Md., 540,499 sq. ft., 78% occupied, valued at \$77 mil. and owned by Fund XV;

First Maryland Bank Bldg. in Baltimore, 344,116 net rentable sq. ft. valued at \$53.4 mil., 100% occupied, owned by Fund XIII;

Parklane Towers, 426,884 sq. ft., valued at \$47.8 mil. which value may not fully reflect asbestos problems, about 92% occupied, and owned by Fund XIV;

Executive Park Atlanta, Ga., 903,116 sq. ft., about 90% occupied, value \$43.5 mil.; owned by Funds XIII, XIV and XVI.

Amer. Natl. Bank Bldg., St. Paul, 337,989 sq. ft., 89% occupied, valued at \$28.5 mil. and owned by Fund XV;

Fairlane Commerce Ctr., Dearborn, Mich., 361,745 sq. ft., value \$26.6 mil.; owned by Funds XV, XVI and 17.

Hallwood intends to seek, first, a recovery in the value of the properties through maximizing cash flow and distributions. Later HRP also may seek to acquire new properties and new investments, all to increase HRP's cash flow. Because it will have a capital base greater than any single underlying LP, Hallwood believes HRP will have greater access to capital markets than any individual partnership. Hallwood believes this will give HRP more growth potential than any single partnership.

Fairness and Litigation: Smith Barney Harris Upham has opined that the transaction, taken as a whole and assuming 100% participation is fair. Smith Barney also reviewed four possible combinations of approval meeting the minimum acceptance level of 50% of total potential units and found them fair. Liquidity Fund, adviser to two investment partnerships which owns units

in Fund REI 83 (owner of Two North LaSalle) has sued 83 REI, Equitec and Hallwood alleging breach of fiduciary duty, and interfering with and conspiring to interfere with business relationship. A California county court sustained a demurrer by 83 REI on June 5.

Opinion: If we are correct that fresh and interesting faces will revive the languishing realty stock market, then HRP has potential for becoming a major player in this new ball game for national real estate stocks. While HRP's concentration in offices

may be perceived as a negative, we think HRP's higher quality urban offices should be among market leaders during the recovery certain to follow today's credit-induced cutbacks in new building. Hallwood's willingness to commit to lower G&A and property management expenses gives HRP a chance to shine where it counts most, in the leasing and stock markets. And Hallwood's intent to pass on the benefits of a leaner, more economical management to unitholders in tangible distributions should be a refreshing change for Equitec investors.